STATE OF ALASKA

DEPARTMENT OF LAW

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The Honorable Frank H. Murkowski
Governor
State of Alaska
P.O. Box 110001
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Re: SCS CSHB 3001(NGD) - relating to the production tax on oil and gas and to conservation surcharges on oil; relating to criminal penalties for violating conditions governing access to and use of confidential information relating to the production tax; amending the definition of "gas" as that definition applies in the Alaska Stranded Gas Development Act; and making conforming amendments (**revised**)
Our file: 883-07-0003

Dear Governor Murkowski:

At the request of your legislative director, we have reviewed SCS CSHB 3001(NGD), which amends the oil and gas production tax statutes in AS 43.55. The bill eliminates the economic limit factor, or ELF, from the production tax calculation and generally changes the basis of the tax from the *gross* value of oil and gas at the point of production to the *net* value of oil and gas: i.e., the value after deduction of costs, including costs incurred upstream of the point of production.

Section 5 of the bill contains the key components of the amended production tax. With several exceptions, oil and gas would be taxed at 22.5 percent of their net value (termed "production tax value" in the bill). When the production tax value of a producer's oil and gas is above $40 per barrel, the tax rate would be increased by a quarter of a percentage point for every dollar by which the value exceeds $40. (For this purpose, the bill provides a method for expressing the amount of gas in barrels based on the BTU content of the gas.) However, producers of North Slope oil and gas are subject to a "tax floor" based on a percentage of gross value, which varies according to the West Coast price of North Slope crude oil. In addition, the bill establishes a "tax ceiling," through 2021, for oil and gas produced in the Cook Inlet sedimentary basin. The ceiling is based on the tax rate on, and the value of, such oil and gas during the 12-month period ending March 31, 2006. Finally, any private landowner's royalty share of oil and gas would be taxed at a percentage of gross value rather than net value.

Section 25 of the bill sets out the details for determining the production tax value of oil and gas. The determination is based on three central concepts: gross value at the point of production, lease expenditures, and adjustments to lease expenditures. Production tax value is calculated by deducting adjusted lease expenditures from gross value.

In large part, the gross value of oil and gas at the point of production would be calculated consistently with the current provisions of the production tax statute. However, several pertinent definitions have been revised in secs. 30 - 33 of the bill, one result of which is that a gas processing plant would be considered to be upstream of the point of production under the bill, not downstream as under current law.

Lease expenditures are generally defined as the ordinary and necessary costs upstream of the point of production that are direct costs of exploring for, developing, or producing oil or gas deposits. The bill establishes standards under which the Department of Revenue (department) may authorize or require producers to treat as their lease expenditures the costs that are billed or billable to working interest owners under a unit operating agreement or similar operating agreement, plus a reasonable overhead allowance. The bill contains an extensive list of categories of costs that may not be counted as lease expenditures and therefore may not be deducted in calculating the production tax value of oil and gas. Under that list, the first $0.30 per barrel of capital expenditures incurred during a calendar year is not deductible.

The bill's provisions on adjustments to lease expenditures are designed to ensure that only *net* costs are deductible. Therefore, producers would be required to subtract from their lease expenditures payments or credits they receive that are in the nature of reimbursements of or offsets to lease expenditures. Adjustments also would be required for revenue from the sale of assets used in oil or gas exploration, development, or production and for fees received for the use of production facilities.

Section 13 of the bill is another core provision of the bill -- it authorizes several categories of tax credits. One is a credit of 20 percent of certain capital expenditures made for oil or gas exploration, development, or production. A second category of tax credit, also allowed at a rate of 20 percent, is for carried-forward adjusted lease expenditures that could not be deducted in the calendar year in which they were incurred because their deduction would otherwise have yielded a negative production tax value. Both of these categories of credits may be transferred to and used by other taxpayers through the mechanism of transferable tax credit certificates issued by the department. Alternatively, small producers may obtain cash refunds for those credits up to $25,000,000 a year, subject to certain conditions.

A third category of tax credit is for producers' "transitional investment expenditures," which are capital expenditures for oil or gas exploration, development, or production that were made during the five years ending March 31, 2006. A 20 percent credit against these expenditures may be taken over a period of approximately seven years, but the credit taken in any year may not exceed 1/10 of the amount of the producer's new capital expenditures made that year. This means that in order for a producer to use the full amount of its potential transitional investment expenditure credits, the producer must increase its capital expenditures by approximately one-third over what it invested during the prior five-year period. Unlike the first two credit categories, transitional investment expenditure credits are not transferable or refundable.

The section also authorizes two other categories of non-transferable credits for approximately 10 years. Producers of oil or gas outside both the North Slope and the Cook Inlet sedimentary basin may be eligible for a credit of up to $6,000,000 against their production tax liability for a calendar year on that oil or gas. In addition, producers averaging no more than 50,000 barrels per day of production may be eligible for a credit of up to $12,000,000 against their production tax liability for a calendar year. The bill establishes a formula under which producers averaging between 50,000 and 100,000 barrels per day of production may be eligible for a fraction of that credit.

Sections 14 - 18 of the bill make conforming amendments to an existing tax credit provision for certain exploration expenditures, extend those provisions until July 1, 2016, and remove a $20,000,000 "cap" on credits for Cook Inlet exploration.

One change to the production tax statute that is reflected in sec. 5 of the bill, and in a number of other bill sections, would make the production tax an annual, rather than a monthly, tax. Section 19 of the bill provides for a single annual tax return, due March 31 of the year following the calendar year for which the tax is levied. Section 7 of the bill requires monthly installment payments of a producer's estimated tax, with any remaining amount of tax due on the March 31 when the tax return is due. Section 12 of the bill provides for interest on either underpayments or overpayments of installments to bear interest at the applicable rate prescribed under the federal Internal Revenue Code, rather than under the existing interest provisions of state revenue law. This substitution of interest rates, however, applies only through the March 31 described above.

It should be mentioned that a revision to sec. 5 of the bill, made late in the legislative process, included an apparently inadvertent change from the phrase "oil and gas produced each calendar year" in AS 43.55.011(e) to the phrase "oil and gas produced each month," as well as the deletion of the term "annual" from the phrase "annual production tax value." This change is inconsistent with the annual tax approach established throughout the rest of the bill and if interpreted as levying a monthly tax would have the absurd result of taxing oil and gas production over the course of a year at 270 percent of the annual production tax value. This is because AS 43.55.160(a), in sec. 25 of the bill, provides for the annual production tax value, not the monthly production tax value, to be used for purposes of AS 43.55.011(e). Therefore, AS 43.55.011(e) should be interpreted as levying an annual tax for the total amount of taxable oil and gas produced during all months of each calendar year.

Section 25 of the bill requires the department to study how the provisions of the production tax statute affect oil and gas activities, investment, revenue, and other pertinent factors and to report the results of its study to the legislature by the start of the 2011 regular session.

In addition to the core changes to the production tax statutes described above, the bill makes numerous other changes in AS 43. These include clarifying that the production tax is deductible for income tax purposes (sec. 3 of the bill); simplifying the tax treatment of flared gas and exempting from the production tax oil used in drilling or production operations (sec. 10); clarifying the role of prevailing value of oil or gas in the production tax calculation (secs. 1 and 11); eliminating a duplicative penalty for non-filing of returns (sec. 20); clarifying that the department may disclose, under safeguards, confidential information to a taxpayer whose tax obligation is affected by the information (sec. 21); and changing the amounts of the oil conservation surcharges imposed by AS 43.55.201 and 43.55.300 (secs. 26 and 28).

Most provisions of the bill, dealing with the substantive changes to the production tax, are made retroactive to April 1, 2006. However, transition provisions in sec. 36 of the bill would allow producers to continue to pay and file under current law for oil and gas produced through the end of 2006; any additional tax owed as a result of the changes in the law will be due March 31, 2007. We note that retroactive changes in tax laws are not uncommon and that, at least where the period of retroactive effect is relatively short as in this bill, the courts have generally upheld such retroactivity as consistent with due process.

The bill has an immediate effective date, which was approved by a two-thirds vote of each house as required by art. II, sec. 18, of the Alaska Constitution.

The bill complies with the single subject and descriptive title requirements of art. II, sec. 13, of the Alaska Constitution. We see no constitutional or other significant legal problems with this bill.

Sincerely,

Deborah E. Behr

for David W. Márquez
Attorney General

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